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SUBJECT: KOREAN ECONOMY SLOWING -- OUTLOOK WEAK FOR FIRST
HALF OF 2009

¶1. (U) This cable is sensitive but unclassified and not/not intended for internet distribution.

¶2. (SBU) Summary: Korean economic growth slowed in 2008 from the 5 percent pace of 2007 to below 4 percent. Growth was already slowing before the impact of the global financial turmoil, but has been further impeded by it. The benchmark KOSPI index fell by more than 40 percent and the won fell by more than 30 percent for the year. GDP growth is expected to reach a maximum of 1.4 percent in the fourth quarter. Export growth is waning rapidly, recording an 18 percent decline in November from a year ago. Industrial output fell by 14 percent in November from the November before. The silver lining is that falling oil and commodity prices have lead to reduced inflationary pressure and improvement in the current account. Looking ahead into 2009, the Korean economy, which depends heavily on the export sector, will be buffeted by the global slowdown and continuing credit crunch until global recovery begins and demand starts to increase. Investment houses, think tanks, and international institutions have presented a wide array of forecasts for ROK GDP growth in 2009 with the majority falling between one and two percent. End Summary.

Korean Economic Performance and Prospects

¶3. (SBU) The Korean economy had already begun to slow in the third quarter of the year, well before financial turmoil in New York precipitated the global liquidity squeeze that began in late September. Korea's GDP growth in the third quarter was 3.8 percent, more than a percentage point below the economy's 2007 performance. Sluggish domestic demand combined late in the quarter with the impact of the global financial turmoil and pushed growth below all but the most pessimistic forecasts. Private consumption grew by just 1.1 percent in the quarter while government expenditure and domestic investment growth were higher at 4.5 percent and and 5.2 percent, respectively. Export growth was 10.7 percent higher than the third quarter of 2007, but low in contrast with the 21.8 percent growth of the preceding four quarters.

¶4. (SBU) While final statistics for the year are not yet available, it is clear that growth in the fourth quarter will be considerably weaker at around 1.4 percent and will drag GDP growth, which stands at 4.7 percent through the first three quarters, to below 4 percent for 2008 as a whole. Increasing government expenditure growth in the fourth quarter is attributable to earlier spending lags and USD 3.2

billion in supplementary budget spending. Growth in private consumption, gross capital formation, and exports are expected to show sharp declines in the quarter.

¶5. (SBU) Korea's equity market was hit hard in late September through November by the global economic turbulence. The Korean economy's declining performance in the third quarter, its thin capital markets, and a large increase in foreign short-term debt left it exposed to the external shock posed by the global financial turmoil. The benchmark KOSPI index ended the year at 1,124, down 40.7 percent (most acutely in October and November). This was the third worst showing ever recorded for the index. The Korean won ends the year at 1260 per U.S. dollar, down by about 28 percent over the last five months. The picture could have been far worse, but the won recovered by 16.6 percent during December. Despite the December recovery, this was the worst performance by the won since the economic collapse in 1997 during the Asian Financial Crisis. Interest rates remain above pre-crisis levels, despite intensive efforts by the BOK to reduce them.

Contributions to GDP Growth by Major Component
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¶6. (SBU) Looking more closely at the components of GDP growth, the steep decline in net export growth will allow exports to yield only a 0.6 percent contribution to GDP growth in the fourth quarter. Weak fourth quarter investment (gross capital formation in the table above) will yield only a 0.3 percent boost to GDP growth in the fourth quarter. Increased government spending is expected to be the biggest

factor in sustaining GDP growth in the fourth quarter, providing a boost of 0.7 percent. The Bank of Korea has slashed its key interest rates by 2 percent since early October and taken other steps to help ease the liquidity crunch. While it is difficult to measure the impact of the monetary loosening in a financial crisis, it should have a stimulatory effect on the economy as the credit crunch gradually eases in 2009. The ROKG plans an aggressive fiscal stimulus for 2009 to make up for the anticipated low levels of private sector economic activity and to complement the monetary action. Since Korea imports almost all of its energy needs, the silver lining in the global financial turmoil has been the collapse of oil prices. This has dramatically reduced import expenditures in the fourth quarter and reversed the current account deficit, thus easing one source of pressure on the won.

¶7. (SBU) Private consumption has been weakening throughout 2008, recording just 1.1 percent growth in the third quarter. Increasing prices, low employment growth, falling asset values, and rising household debt have all contributed to this weakness. Despite the easing of oil and gas prices, core inflation and the weak won are still limiting demand for non-necessities. The negative wealth effect is a relatively new factor in the picture as equity and real estate values fell most heavily in the fourth quarter. The impact on Korea of the global credit crunch has also reduced consumer credit and furthers limits demand. These new developments in an already weak environment lead to the expectation that private consumption growth will reach only 0.1 percent in the fourth quarter. Consumer confidence survey scores in December fell to the lowest level in ten years. Demand is expected to remain weak through at least the first and second quarters of ¶2009.

¶8. (SBU) Investment growth is expected to fall by 1.4 percent in the fourth quarter of 2008 in comparison with the third quarter. This will bring the annual investment growth figure for 2008 to around 2.4 percent, slightly lower than in 2007. The poor overall economic environment is also likely to lower investment in new plant and equipment in at least the first two quarters of 2009. The BOK announced in late December that facility investment in the fourth quarter was 7.2 percent lower than in 2007. The BOK anticipates declining facility investment in 2009. Increasing ROKG construction

spending will not have a significant impact on the economy until the first and second quarters of 2009, although the supplementary budget measure in September did boost spending modestly in the fourth quarter. In any case, increasing government construction spending is only likely to offset partially otherwise declining private sector construction activity in the first half of 2009. While President Lee Myung-bak had promised increased infrastructure spending during his campaign in 2007, these plans did not get off the drawing board in 2008 as the Administration was bogged down by other issues.

¶9. (SBU) The real estate and housing market is moribund with large stocks of finished but unsold apartments accumulating in the fourth quarter. This problem is particularly pronounced in the regions beyond Seoul where the previous Roh Administration had promoted development and construction. Construction firms and mutual savings banks heavily invested in these regional projects are clearly among those most likely to be put out of business as the government is expected to move forward with restructuring in these and other sectors in 2009. The Lee Myung-bak Administration is pushing forward a number of real estate reforms that had been stalled in order to stimulate the market. While these measures may yield positive results, the effect is unlikely to be substantial at the outset of 2009.

¶10. (SBU) Government expenditure growth was only 4.2 percent through the first three quarters of this year. This in part was the result of the budget austerity stance at the start of the Lee Myung-bak Administration. Total government spending through the first ten months of 2008 was 197.7 trillion won (USD 141.2 billion), only 75.9 percent of the annual budget. The supplementary budget of 4.5 trillion won (USD 3.2 billion) passed in September was insufficient to reverse the low spending growth trajectory established through the first 9 months. The expected increase in spending in the fourth quarter will boost the annual rate of government spending growth to 4.5 percent. Government spending is expected to grow significantly in 2009 as the budget already contains a fiscal stimulus and an additional stimulus package is expected.

Employment and Wages

¶11. (SBU) Unemployment rates are not expected to increase substantially in the fourth quarter, despite the slowing of the economy. Unemployment is expected to be 3.3 percent in the fourth quarter, only slightly higher than the rate through 2007. One reason for this is the increasing rate of economic inactivity within the overall population. Another factor is the tendency in Korean firms to reduce output and hours rather than lay off workers. Nonetheless, job losses are anticipated in 2009 through the coming economic restructuring in construction, shipbuilding and possibly other sectors. Temporary and day laborers, along with the self-employed, are expected to face the toughest conditions. Many of these are actually foreign migrant workers.

¶12. (SBU) Even as employment growth has slowed in 2008, so have real wages slowed and then turned negative. Real wage growth was 2.3 percent in the first quarter, 1.6 percent in the second quarter, but minus 2.9 percent in the third quarter. Real wages are expected to continue to decline in the fourth quarter as workers are in a weak bargaining position and inflation remains substantial. This trend could continue into 2009 unless inflation is brought within the target zone. Declining real wages will further undercut consumer demand in the fourth quarter and into at least the first quarter of 2009.

External Sector

¶13. (SBU) Net export growth through the first three quarters of 2008 was 20.2 percent higher than the same period in 2007. This growth, however, slowed in the third quarter to 10.7 percent and is expected to deteriorate sharply in the fourth quarter. Exports in November fell by 18 percent from the level of November 2007, the sharpest drop in seven years. Similarly, the National Statistical Office announced a 14 percent decline in industrial production in November (from the level of Nov 2007) -- the sharpest monthly decline since ¶1970. Despite slowing export growth, the trade balance swung into positive territory in October with a USD 2.79 billion surplus, reflecting the impact of rapidly falling oil and commodity prices. This change helped propel the current account into a USD 4.75 billion surplus in October and a USD 2.06 billion surplus in November. For the year, we expect a surplus of more than USD 5 billion for the goods balance, while the services balance is expected to be around minus USD 14 billion. The positive movement in the trade and current account balances late in 2008 has not improved exporter confidence levels. The Export Business Survey Index, taken quarterly by the Korean International Trade Association for the coming quarter, peaked at a level of 128.3 in the first quarter of 2008. The index fell to 90.6 in the second quarter, 82.8 in the third quarter, and reached a record-low of 33.4 in the fourth quarter.

¶14. (SBU) Prospects for the external sector have directly and indirectly affected by the financial crisis. The global credit crunch has made trade financing more difficult for imports and exports. The Korean government has attempted with mixed results to ensure adequate trade financing. Recessionary expectations in the United States and Europe are darkening global growth expectations and many of Korea's export industries will feel the pain. The won depreciated rapidly in October and November, reaching 1508 per U.S. dollar on November 21, losing more than 50 percent of its value of just a few months before. The won, along with most other currencies, has regained value against the dollar in December with the rate on December 30 closing at 1260 won per U.S. dollar. Market analysts expect the won to recover further against the dollar but most expect the rate to stabilize above 1100 with the currency then 15-25 percent

weaker than in the first half of 2008. This should make Korean exports more competitive over time, particularly in comparison to those of Japan, where the yen has appreciated.

Inflation and Monetary Policy

¶15. (SBU) Consumer prices in 2008 were propelled upward by rising energy, commodity and food prices in the first half. As these prices moderated and then fell in the second half, consumer price pressures began to ease. Consumer prices for the year as a whole are expected to rise by 4.7 percent, well above the target zone of 2.5-3.5 percent. Producer prices climbed even higher during the year, peaking at 12 percent in the third quarter. These prices are expected to end the year with an annual growth rate of 8.6 percent. Inflationary pressures are generally expected to continue to ease in the first half of 2009, although upside risks spring from the weaker won, possible public utility price hikes, and possible increased labor wage demands.

¶16. (SBU) The impact of the global financial turmoil (including easing energy and commodity prices) caused the Bank of Korea (and the Ministry of Strategy and Finance) to abandon anti-inflationary policies of the summer months in favor of monetary easing in the fourth quarter. The BOK cut the benchmark seven-day repurchase agreement by 75 basis points on October 27, 25 basis points on November 7, and a full percentage point on December 11. Analysts generally expect additional monetary easing in the first half of 2009 and indeed, BOK Governor Lee Seong-tae in New Year remarks announced that the bank would "manage the base rate with priority on economic recovery and improving financial markets because price growth is expected to slow down."

Wide Range of 2009 Forecasts

¶17. (SBU) The most pessimistic forecast for the Korean economy in 2009 was released by UBS, which predicted in late November a 3 percent GDP decline. UBS expects the heavy blow to export industries coming in early 2009 to burst what it considers to be a credit bubble. Some other western investment houses have also predicted negative growth in 2009, but most western and domestic institutional analyses are more positive.

¶18. (SBU) The OECD is among the more optimistic of forecasters and, in its &Economic Outlook 20098 anticipates GDP growth of 2.7 percent for the coming year. The OECD suggests a quicker rebound for exports than most other institutions. The OECD analysis foresees the weak won as a spur to exports (but the won has recovered considerably in December). The IMF and World Bank have both announced expectations of 2 percent for Korean GDP growth in 2009.

¶19. (SBU) The BOK, which has a reputation for optimism when forecasting Korean GDP growth, surprised most observers in December with a forecast of only 2 percent GDP growth for
¶2009. The BOK was less optimistic than the OECD about a quick turnaround in demand in export markets as well as domestically. With the exception of Samsung Economic Research Institute, which is predicting 2009 GDP growth of 3.2 percent, Korean think tanks are forecasting growth between 1 and 2 percent. President Lee Myung-bak warned in late December that growth in the first half of 2009 could be negative, but was hopeful regarding positive growth for 2009 as a whole.

Comment

¶20. (SBU) President Lee Myung-bak has made shoring up the economy his highest domestic priority in late 2008 and is expected to make it a primary theme in his New Year's address. Lee and the ruling GNP are trying to move forward with a wide-ranging set of reforms intended to help the economy weather the global slowdown as well as create an environment more conducive to business interests. Lee and

the GNP are, however, at loggerheads with the opposition Democratic Party, which seized the floor of the National Assembly in late December to prevent the GNP from using its majority to pass any legislation. (The GNP's majority was used to pass the budget and tax cuts earlier in December over strenuous objections of the DP). The economic crisis offers Lee a rare opportunity to regain the initiative in his Presidency and the opposition is using radical tactics to prevent this outcome. Regardless of the outcome of the legislative standoff, the government has used the tools available to it, along with the budget and tax measures, to adopt expansionary fiscal and monetary policies, ease regulatory controls, ease the liquidity crisis facing the financial sector, shore up bank capital adequacy ratios, and prepare for restructuring in industries such as construction and shipbuilding.

¶21. (SBU) The financial crisis appears to have generated the necessary urgency to spur Korea and its larger neighbors, China and Japan, to adopt a new set of bilateral national currency swap mechanisms on the margins of the mid-December summit in Fukuoka. Nonetheless, the ROKG remains greatly appreciative of the USD 30 billion currency swap between the Federal Reserve and the Bank of Korea. This gesture played a key role in stabilizing Korean markets in late October when fear and uncertainty were accelerating the decline of the won and stock indices. The ROKG is also appreciative of the U.S. role in ensuring a place at the table for Korea at talks on the global financial system and we can expect the ROKG to continue to be an ally in these talks.